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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

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The Deficit

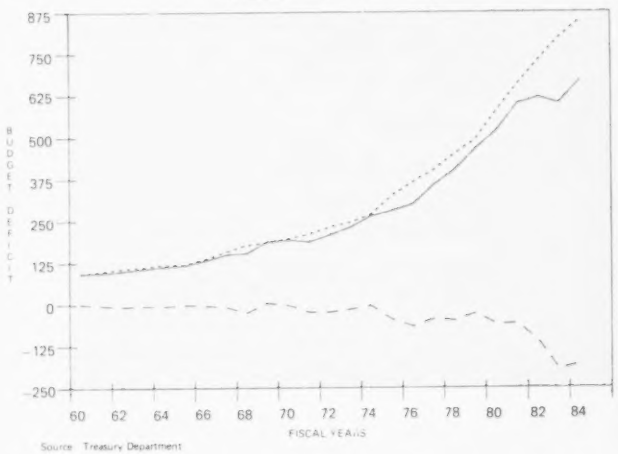
The Federal government's budget deficit is getting to be like the weather: everybody talks about it, but nobody does anything about it. The debate will surely intensify over the next few months, as Congress, business, the press, and economists react to the Administration's budget proposals for the next few years, which project a string of mega-deficits as far as the eye can see. Most economists, myself included, are extremely concerned about this. But this is where the unanimity ends. There is a division of opinion over why the deficit got so large, and what needs to be done to bring it down. There is also uncertainty as to when the current and projected deficits will begin to adversely affect the economy.

Why It Grew

The first thing that readers should be aware of is that, at the Federal level, annual budget deficits are nothing new. In the postwar era, Washington has run four deficits for each budget surplus; in the past quarter of a century there were only two years in which the budget was not in deficit. Yet, the economy managed to grow and prosper throughout this era because these deficits were relatively small, compared with the size of the economy, the financial markets, savings and so forth.

All this changed starting in 1981. It was then that the Economic Recovery Tax Act (ERTA) was passed. It called for an across-the-board reduction in individual income tax rates and other reductions in individual income taxes; the annual adjustment of the zero bracket amount, the personal exemption, and individual income tax brackets for inflation beginning in 1985; and the accelerated cost recovery of capital expenditures. As you can see from Chart I, government revenues, which had tracked expenditures fairly closely over the years, fell away starting in fiscal 1982, immediately upon passage of ERTA. No only did this widen the budget deficit for fiscal 1982 and 1983, it caused deficits projected for the future to remain large, thereby setting up the present budget quandary.

CHART I
FEDERAL BUDGET RECEIPTS (LINE), OUTLAYS (DOT)
AND BUDGET SURPLUS OR DEFICIT (DASH)
<BILLIONS OF DOLLARS>



Source: Treasury Department

As you know, the tax cut was supposed to eventually increase revenues to help close the budget gap. Instead, the tax cut widened it: The Office of Management and Budget estimates that ERTA, generating progressively larger annual losses in revenues, will cost the government $627 billion in tax revenues between 1982 and 1986. This is about four-fifths of the $785 billion cumulative deficit that the Administration now believes it will run during this time.

In one sense the President kept his promise when he said he would reduce the burden of government on the economy, since receipts as a percent of GNP were 18.6 percent in 1983—down from 20.1 percent in 1980. In another sense, however, his promise was not kept since Federal spending went from 22.4 percent of the GNP in 1980 to 24.7 percent in 1983. And the true burden of government in our economy is measured by spending—not by how it is financed.

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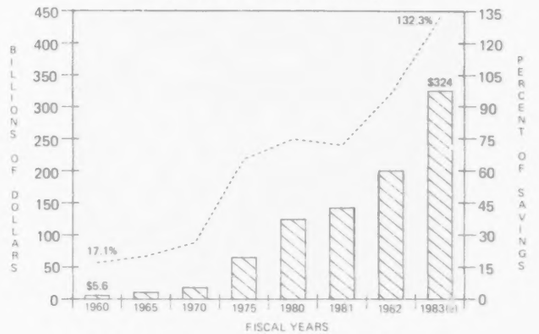
To sum it up, then, politicians have always had a tendency to spend money faster than the government was taking it in. And since the economy did not seem to suffer—indeed, at times it benefited from increased Federal spending and budget deficits—there didn't seem to be any reason to change things. So in one sense, the current deficit is a byproduct of a long-standing political process, which generated ever-increasing amounts of spending just a step or two ahead of revenues. However, the larger part of the current and projected future budget deficit traces to the tax cut program of 1981 which stunted the growth in revenues instead of accelerating it, as the Administration thought would be the case.

What It Means

To fully assess the impact of the budget deficit on the economy, it is necessary to separate the past and present from the future. The budget deficits posted in 1983 and the early part of 1984 undoubtedly had a positive impact on the economy while those projected for the latter part of this year and for 1985 and beyond would appear to have adverse consequences. The positive effects on the economy in 1983 were traditional in nature: Lower Federal taxes meant higher after-tax incomes for consumers and business. When combined with easier money and lower interest rates, this resulted in the burst of consumer spending that was responsible for getting the current economic recovery underway. Of course, the recovery was not as strong as it might have been, since interest rates adjusted for inflation remained above historical norms because the markets feared the financial consequences of these huge deficits. This limited the number of people who could buy such big-ticket items as a new car and a new house. It also constrained businessmen's willingness to invest in capital goods. And, of course, by raising the value of the dollar far above its economic worth, it cut into exports while encouraging imports.

If the deficits projected for the second half of 1984 and for 1985 were sharply lower than the deficit for 1983, these restraints on economic recovery would probably diminish and the economy would continue to expand. However, the deficits are not expected to decline significantly. What is more, most projections—including the government's—estimate that Federal budget deficits will remain close to present levels for many years into the future. It is at this point that the negatives of the deficit begin to outweigh the positives. The credit sensitive sectors will continue to lag behind the rest of the economy as will export industries and those that compete with goods imported from abroad. Interest rates will have to go higher in both nominal and real terms in order for private borrowing to decline enough to make room for increased government borrowing. One wonders how much further this process can go: As you can see from Chart II, the government in 1983 borrowed an amount equivalent to over 130 percent of the net savings generated in that year, up from only 17 percent in 1960.

CHART II
TOTAL FEDERAL BORROWING (BAR) VS.
TOTAL FEDERAL BORROWING
AS A PERCENT OF SAVINGS (DOT)



Source: Office of Management and Budget; Bureau of Economic Analysis

If crowding out isn't enough to worry about, how about uncontrollability? The longer we wait to cut the deficit, the more difficult it becomes to do so. This is because of the skyrocketing cost of servicing the debt. The national debt and interest on that debt are now rising faster than the gross national product. In 1980 the national debt was $914 billion, or about 35 percent of the GNP. By 1983 it had surged to $1.4 trillion, or 43 percent of GNP—and OMB predicts that by 1986 the national debt could amount to $2 trillion or nearly half of GNP (Chart III).

Now there has been a lot of talk about what is controllable and what isn't controllable when it comes to government spending. In reality, there is only one uncontrollable government expense: Interest cost. Given enough time and willpower, the government can cut any other expenditure—but it must meet its debt-service payments or face default.

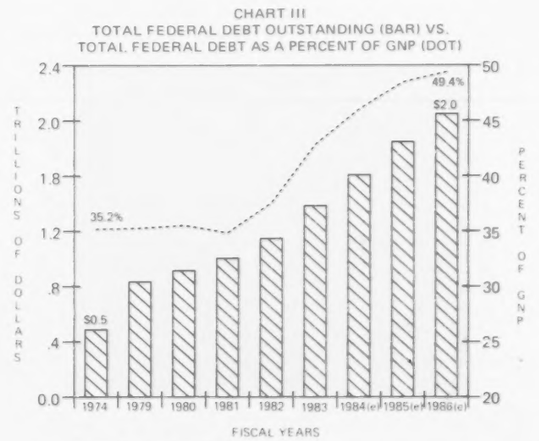
Here's where a major problem looms. Unless interest rates fall sharply or the budget is balanced swiftly, interest costs on the national debt will continue to rise. This is because a growing debt means that more securities will have to be issued. OMB predicts that by by 1988, annual interest costs will total more than $150 billion, 13½ percent of expected spending levels—and almost double that year's projected deficit!

How To Cut It

Like the impact of the deficit on the economy referred to above, cutting the deficit must be viewed in two ways. The deficit is such a critical problem that it must be attacked immediately—notwithstanding the fact that this is a Presidential election year. This suggests a short run approach. By the same token, since the deficits, themselves, did not materialize suddenly but have been part of the scene for decades, another approach should also be implemented, although its effects might not be felt for a longer period of time.

In case you haven't figured it out, the short run approach must be to raise taxes. Since fiscal 1984 is already one-third over, it will be difficult—if not impossible—to cut spending enough in the current fiscal year to make more than a tiny dent in the budget deficit. What is more, given the composition of Federal spending, it may be just as tough to cut outlays scheduled for fiscal 1985 as well: Military and international spending make up over 30 percent of the budget, spending on such entitlement programs as Social Security, Medicare and farm price supports accounts for 50 percent, while net interest on the national debt constitutes 12 percent for a total of over 90 percent. The remaining outlays, including grants to states and local governments amount to nearly $70 billion, or less than 40 percent of the current budget deficit. Thus, even if they were cut out entirely, we would still be left with a deficit of well over $100 billion.

CHART III
TOTAL FEDERAL DEBT OUTSTANDING (BAR) VS.
TOTAL FEDERAL DEBT AS A PERCENT OF GNP (DOT)



Source: Office of Management and Budget

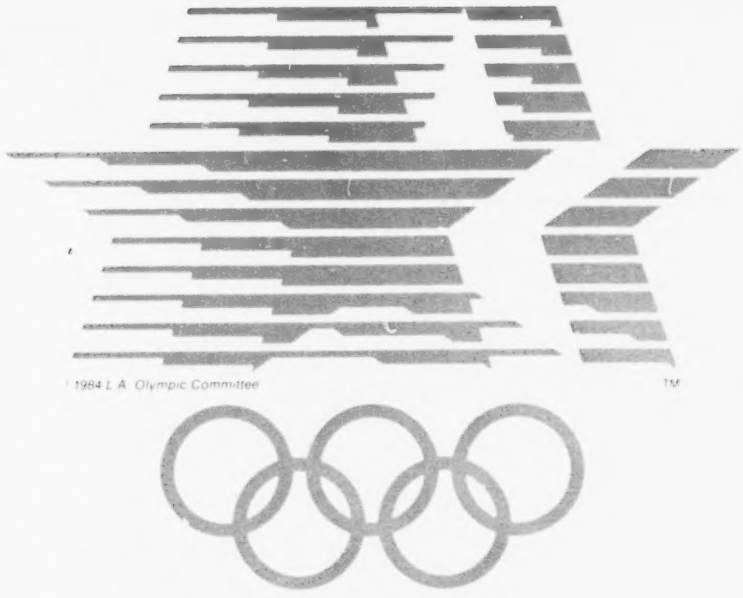
On the other hand, there is probably a lot that could be cut from government spending. The President's Private Sector Survey on Cost Control recently suggested that Washington could save nearly $425 billion over the next three years if it adopted some 2,500 recommendations to eliminate waste, reduce Federal retirement benefits, and, in general, put Federal operations on a more businesslike footing. And while most of the panel's recommendations to save money would require the assent of Congress, whose lawmakers have refused in the past to approve such proposals, about 27 percent, or $115 billion worth of cost reductions could be achieved through administrative action. If this panel is on track, and there is every reason to believe it is, then government spending can be reduced without weakening our defense posture and without cutting into necessary social welfare programs.

However, these recommendations cannot be achieved overnight. Of necessity, they must be considered long run—albeit vitally important—in nature. But the mounting size of the Federal debt and its accompanying interest costs suggest that immediate steps must be taken. Not only will shrinking the deficit today be easier than doing it tomorrow, but it will also ensure that the economic recovery will have a chance of surviving beyond 1984. As the May 1983 Economic Report said: "Government spending ought to be curtailed, to be sure—but government revenues must be restored in the meantime."

Conclusions

The bottom line to this discussion is simple. While the economy has been able to survive deficits in the past, it has never before encountered ones of today's magnitudes relative to the economy without significant side effects. There is no need to hunt for the villain in this deficit scenario—everyone deserves a share of the blame. Responsibility for today's deficits lies with the Congress, this and previous Administrations—and the American people who have continually asked for more from Washington than they were willing to ante up in the form of taxes.

What matters at this point is that the deficit must be tackled immediately, if not sooner. Today's deficit may be boosting economic activity but tomorrow's will surely curtail it. Cutting the deficit quickly may be hard, but waiting until after the elections will not make the job any easier. H



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Business Conditions Update

Ordinarily, this would be a time for cheer. The U.S. economy is barely into its second year of economic recovery, and history shows that, on average, postwar business expansions have lasted around three years during peacetime; four years including periods of war. This is a Presidential election year, and the economy has usually done well during these periods of increased political activity. More specific to the current expansion, consumers, business, as well as the banking system have rebuilt liquidity, suggesting that money is available to be spent. Inflation has moderated, meaning that dollars can go further, and while the unemployment rate remains uncomfortably high, the employment rate is well above its postwar average, reflecting a record number of people at work.

Yet, a feeling of unease seems to be developing. The stock market fell almost nonstop earlier this year as investors, transfixed by the Federal government's mammoth budget deficits and the Federal Reserve's unwillingness to ease its grip on the money and credit aggregates, came to the conclusion that no near-term decline in interest rates was likely. Rather, the opposite appeared to be the case: Interest rates seemed likely to rise, especially if business loan demand picks up, as it usually does both at this time of year and at this stage in an economic recovery. To the stock market, rising interest rates are anathema, since they represent not only competition in terms of immediate rates of return available on debt instruments, but they also suggest that business profitability may soon slow owing to rising costs of borrowing money, and a reduced rate of sales. And since many individuals and businesses rely on the stock market to generate wealth, hence buying power, not to mention as a measure of confidence, a deep enough fall in stock prices (this one has already shaved some $150 billion from household net worth) could bring on a contraction in economic activity—sort of a self-fulfilling prophecy.

While the stock market is a leading indicator of business activity it is not an infallible one. Every recession in the postwar era has followed a drop in stock prices—but not every drop in stock prices has been the forerunner of a recession. In other words—many traders and investors tend to overact to economic, financial and political developments. This may be one of these times, because when one moves away from Wall Street to Main Street, the scene brightens considerably.

Domino Theory

For over 60 years, every economic expansion but one lasted at least 21 months. There must be a reason for this. And the reason, as I see it, is that once a recovery gets underway, it develops a certain momentum not unlike a series of dominoes, which will fall one after the other once the first is pushed. The current expansion appears to be no different than the majority. The drop in interest rates that began in the middle of 1982 sent the stock market soaring and consumers flocking into showrooms to buy new cars and to lots to buy new houses. As these two industries recovered, they provided increased demand, not only for employees who produce these goods, but for the supplier industries as well. The entire consumer sector soon blossomed out and was a feature of the first year of recovery in 1983.

CIVILIAN EMPLOYMENT: CURRENT RECOVERY (LINE)
VS. AVERAGE OF PRIOR 7 RECOVERIES (DOT)
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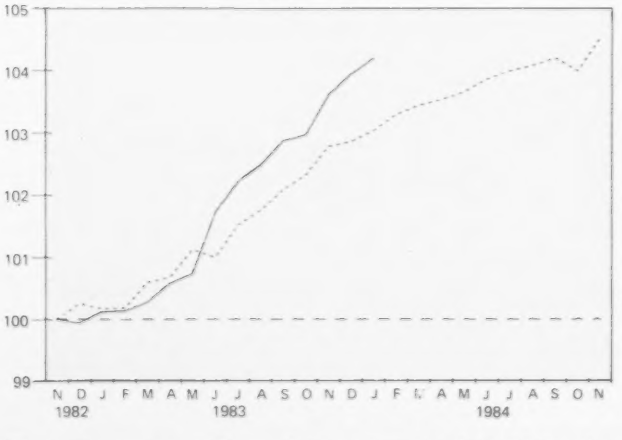

The consumer still has plenty of power left. Not only has the unemployment rate fallen faster than at any time in 30 years, but nearly 4¼ million jobs have been

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added so far in the current economic recovery. As you can see from the chart on page one, this represents an increase of 4¼ percent from employment levels prevailing at the end of the last recession; at this stage in the seven previous postwar recoveries, the rise in civilian employment was only about three percent, on average. To make matters even more interesting, hours worked have increased twice as fast as they usually do at this point in a business expansion.

These increased hours have fattened the wallets and boosted the morale of many people. The wages and salaries component of personal incomes increased nearly 8½ percent in 1983 compared with just four percent a year earlier. When you combine this with a consumer price inflation rate that was as low in the 12 months ending December 1983 as it was in the comparable period of 1982, you can see why consumers' confidence in January soared to its highest level in five years.

This alone should be enough to assuage fears for the business expansion. Consumer spending, as you know, accounts for two out of every three dollars that make up our gross national product. As long as employment and hours worked are rising and inflation remains low, people will find their buying power increasing, thus their willingness to spend growing as well. And there certainly would seem to be a lot of unfulfilled demands. Take automobiles, for example. While the annual selling rate of new domestic cars in January topped eight million units, this is still below levels first reached 11 years ago, when the population was much smaller. The average car on the road today continues to get older, and at 7¼ years of age, is the oldest since 1950. With spring on the way and many of Detroit's cars new in style or concept, don't overlook the possibility that auto sales will surge in the months ahead—giving another fillip to economic activity.

Housing is another sector that could be in for a pleasant surprise. Although the level of housing starts reached 1.9 million in January, it is still more than a half million units below levels first reached in 1972—when the number of people in the 25-34 year age bracket, the peak homebuying group, was one-third smaller than today.

To be sure, mortgage interest rates are still high. After having fallen to about 12½ percent last spring, they have since ticked upward to around 13½ percent, nationwide. However, this is a misleading average, since it is for a so-called conventional, fixed-rate loan, and most mortgage loans are now being made on a variable rate basis with interest rates during the first year or so far below that of the fixed-rate loan. These "creative" mortgages, combined with concessions from builders, are helping an increasing number of people buy homes who otherwise would not be able to. Needless to say, if housing strengthens further, so will the supplier industries, as well as the market for home furnishings.

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Business Adds Strength ...

While consumers continue to spend in the second year of an economic recovery, much of the incremental strength is derived from the business sector. The present expansion finds the business sector making a contribution. Spending on inventories is growing, in contrast to the liquidation that characterized the first half of 1983. The change from liquidation to accumulation added nearly 50 percent to the economy's growth rate in the second half of 1983. Further gains are likely, since even this turnaround in inventory building has not been enough to keep pace with rising sales. The ratio of inventories to sales in manufacturing and trade is now at its lowest point in the postwar era. Obviously this spells shortages in many lines, so it would not be unreasonable to expect some modest step-up in the rate of inventory building in the next few months.

Business is also spending heavily on capital goods. Since midyear 1983, expenditures on business structures have risen at more than an 11 percent annual rate, after having fallen nonstop during the six previous calendar quarters by $18 billion, or eight percent at annual rates. But the big jump has come in business equipment. Outlays for these items, which include computers, word processors, telecommunications facilities and the like, jumped by 19 percent from fourth-quarter 1982 to fourth-quarter 1983, paced by a rise at an annual rate of 27 percent in the second half of last year.

February, 1984
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1983				YEAR 1983		1984				YEAR 1984	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3171.5	3272.0	3362.2	3432.0	**3309.4**	**7.7**	3519.4	3592.1	3664.5	3739.1	**3628.8**	**9.6**
GNP: $72	1490.1	1525.1	1553.4	1570.5	**1534.8**	**3.3**	1590.5	1607.2	1622.6	1636.6	**1614.2**	**5.2**
% Change, Annual Rates	2.6	9.7	7.6	4.5	**3.3**		5.2	4.3	3.9	3.5	**5.2**	
Consumption	2073.0	2147.0	2181.1	2233.1	**2158.6**	**8.4**	2270.4	2315.7	2360.5	2402.1	**2337.2**	**8.3**
Durables	258.5	277.7	282.8	295.2	**278.6**	**14.0**	299.9	309.2	317.9	324.1	**312.8**	**12.3**
Non-Durables	777.1	799.6	814.8	825.9	**804.3**	**5.7**	837.5	850.9	863.8	875.9	**857.0**	**6.6**
Services	1037.4	1069.7	1083.5	1112.0	**1075.7**	**9.0**	1133.0	1155.6	1178.8	1202.1	**1167.4**	**8.5**
Investment	404.1	450.1	501.1	529.8	**471.3**	**13.7**	555.7	560.3	574.3	590.0	**570.1**	**21.0**
Non-Residential	332.1	336.3	351.0	371.2	**347.7**	**0.2**	377.8	386.9	396.7	406.6	**392.0**	**12.8**
Producers Durable Equipment	199.3	208.8	220.2	236.8	**216.3**	**4.8**	240.8	246.1	252.0	258.0	**249.2**	**15.2**
Structures	132.9	127.4	130.9	134.5	**131.4**	**-7.4**	137.0	140.8	144.7	148.6	**142.8**	**8.7**
Residential	111.3	128.4	141.5	140.8	**130.5**	**43.8**	146.1	149.1	152.1	153.8	**150.3**	**15.1**
Inventory Changes	-39.4	-14.5	8.5	17.7	**-6.9**		31.9	24.3	25.6	29.5	**27.8**	
Net Exports	17.0	-8.5	-18.3	-32.6	**10.6**		-25.5	-29.4	-32.2	-35.2	**-30.6**	
Government Purchases	677.4	683.4	698.3	701.7	**690.2**	**6.3**	718.7	745.4	761.9	782.2	**752.1**	**9.0**
Federal Defense	194.4	199.4	201.2	206.2	**200.3**	**11.6**	214.2	221.2	227.0	236.2	**224.6**	**12.1**
Federal Civilian	79.1	74.3	76.9	69.4	**74.9**	**-5.5**	70.8	80.9	82.0	84.0	**79.4**	**6.0**
State & Local	404.0	409.7	420.2	426.1	**415.0**	**6.3**	433.7	443.4	452.9	462.0	**448.0**	**8.0**
Final Sales: $72	1505.5	1530.5	1549.7	1563.0	**1537.2**	**2.8**	1577.1	1597.1	1612.0	1624.6	**1602.7**	**4.3**
% Change, Annual Rates	0.6	6.8	5.1	3.5	**2.8**		3.6	5.2	3.8	3.1	**4.3**	
GNP Price Index (1972 = 100)	212.8	214.6	216.4	218.5	**215.6**	**4.2**	221.3	223.5	225.8	228.5	**224.8**	**4.3**
% Change, Annual Rates	5.5	3.3	3.6	3.9	**4.2**		5.1	4.1	4.3	4.7	**4.3**	
PCE Deflator (1972 = 100)	210.1	212.5	214.7	216.3	**213.4**	**3.9**	218.4	220.6	222.9	225.3	**221.8**	**3.9**
% Change, Annual Rates	2.1	4.6	4.2	3.0	**3.9**		3.8	4.1	4.3	4.4	**3.9**	
Consumer Price Index (1967 = 100)	293.5	296.6	300.0	303.6	**298.4**	**3.2**	306.7	309.9	313.4	316.8	**311.7**	**4.4**
% Change, Annual Rates	-0.4	4.2	4.8	4.8	**3.2**		4.2	4.3	4.5	4.5	**4.4**	
Total Personal Income	2657.8	2713.6	2761.7	2834.2	**2741.8**	**6.3**	2892.1	2940.2	2993.7	3050.8	**2969.2**	**8.3**
Disposable Personal Income	2255.9	2301.0	2361.7	2423.6	**2335.5**	**7.3**	2471.4	2511.6	2555.9	2603.3	**2535.5**	**8.6**
Savings Rate	5.4	4.0	4.9	5.1	**4.9**		5.4	5.0	4.9	5.0	**5.1**	
Employment Rate	55.6	55.9	56.6	57.0	**56.3**		57.4	57.7	58.0	58.2	**57.8**	
Unemployment Rate	10.4	10.1	9.4	8.5	**9.6**		8.1	7.9	7.8	7.7	**7.9**	
Indus. Production (1967 = 100)	138.5	144.5	151.8	156.0	**147.7**	**6.5**	159.0	161.1	162.7	164.6	**161.9**	**9.6**
Housing Starts (000)	1694.3	1683.0	1790.7	1692.0	**1715.0**	**62.0**	1771.0	1802.2	1768.1	1738.0	**1769.8**	**3.2**
Domestic Auto Sales (000)	6066.7	6933.3	6947.7	7220.7	**6792.1**	**18.0**	7813.3	7952.2	7895.8	7986.3	**7911.9**	**16.5**
Corporate Pre-Tax Profits	169.7	203.3	229.1	224.2	**206.6**	**18.6**	230.6	242.3	250.6	258.6	**245.5**	**18.9**
- Taxes	61.5	76.0	84.9	83.0	**76.3**		85.6	90.7	94.0	97.3	**91.9**	
Net Profits	108.2	127.2	144.1	141.2	**130.2**	**13.1**	145.0	151.6	156.6	161.4	**153.6**	**18.0**
- Dividend Payments	71.4	72.0	73.7	75.9	**73.3**	**6.7**	78.3	80.6	82.9	85.1	**81.7**	**11.6**
Undistributed Profits	36.7	55.2	70.4	65.3	**56.9**	**22.7**	66.7	70.9	73.7	76.3	**71.9**	**26.4**
+ Depreciation	242.2	255.4	270.7	281.4	**262.4**		290.7	295.6	301.0	306.6	**298.5**	
- Inventory Profits	1.7	10.6	18.3	8.5	**9.8**		13.8	17.9	21.8	22.7	**19.1**	
Net Cash Flow	277.2	300.0	322.8	338.2	**309.6**	**19.5**	343.6	348.6	352.9	360.2	**351.3**	**13.5**

... But Not Everywhere

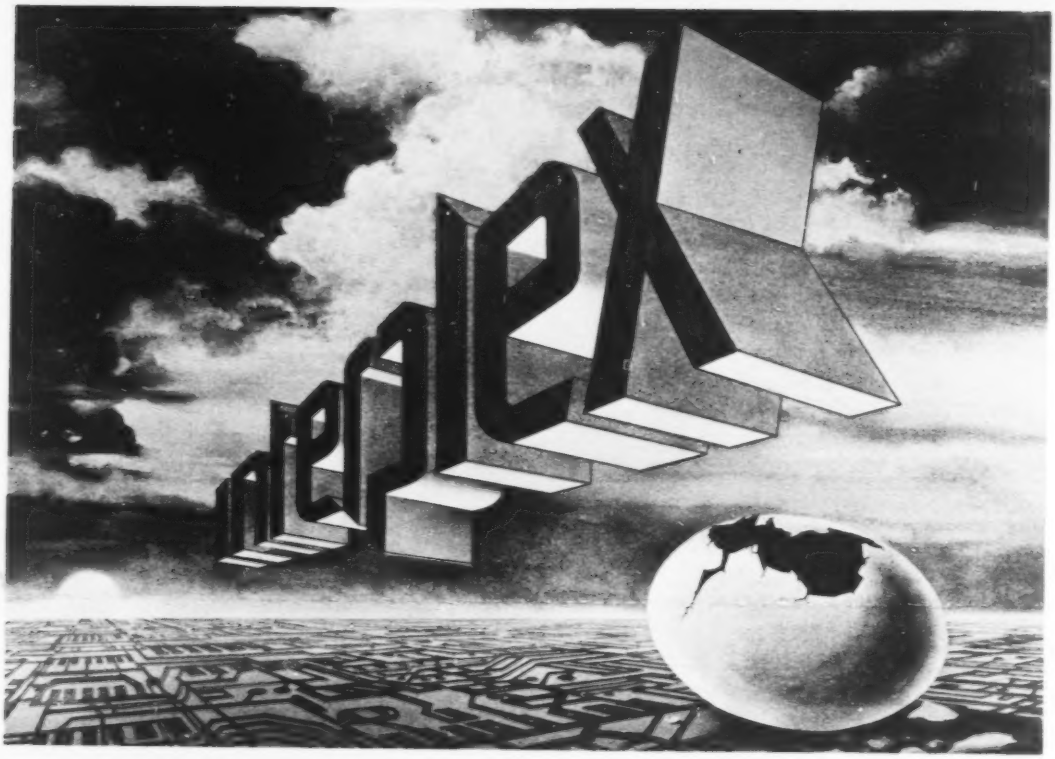
If there is a sector that is not making its normal contribution to economic growth it is foreign trade. Because the dollar remains overvalued compared with other key currencies, many goods produced in the United States are simply too expensive when sold abroad. By the same token, goods produced overseas are very cheap when sold in the United States. In 1983, the decline in net exports lopped nearly $21 billion off the real gross national product. This may not seem like much in a $1.6 trillion (real terms) economy until you realize that fourth-quarter 1983's real GNP was only $90 billion above the year before. If net exports had remained unchanged over this period, fourth-quarter 1983's real GNP would have been 7½ percent above its year-ago level, instead of the six percent rise it posted.

Looking at the overall private economy, therefore, it would appear that only the foreign trade sector is seriously dragging. However, if you consider the stimulus of increasing defense spending and the consistent growth in state and local outlays, it is hard to see how the stock market's fears can be justified. To be sure, it now appears that the combination of continued deficit spending by Washington and a relatively restrictive monetary policy does spell an increase in interest rates, at least in the shorter end of the maturity scale. But this alone should not justify a drop in stock prices.

The economy has demonstrated a remarkable ability to grow in the face of interest rates which, while down from their 1980-82 peaks, nonetheless are high by historical standards—especially in real terms. This should allay some fears regarding corporate profitability. Second, bond market interest rates, which, in the final analysis, are the real competitors with stock yields, are unlikely to rise significantly over the course of this year and may even hold steady. This is precisely because of the monetary policy noted above. By keeping a relatively tight rein on the supply of money and credit, the Federal Reserve is virtually ensuring that a new round of rapid inflation will not reappear in the foreseeable future. Since bond yields are also unusually high relative to inflation, it would seem that if inflation can be kept to the four-five percent range depicted in the table, there would be no reason for them to go up further.

Conclusion

Thus it would appear that the outlook for 1984 remains bright. If this is, indeed, the case, equity investors, as they have done many times in the past, may be worrying needlessly. Of course there is always the possibility that 1985 will be a poor year. With only two exceptions, we have had a recession in every post-Presidential election year since 1945. H



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